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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
	)	
Rate Regulation	)	

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

COMMENTS ON THIRD FURTHER NOTICE OF PROPOSED RULEMAKING BY AUSTIN, TEXAS; DAYTON, OHIO; DUBUQUE, IOWA; GILLETTE, WYOMING; KING COUNTY, WASHINGTON; MONTGOMERY COUNTY, MARYLAND; THE CITY OF ST. LOUIS, MISSOURI; AND WADSWORTH, OHIO

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September 30, 1993

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SUMMARY

1. Austin, Texas; Dayton, Ohio; Dubuque, Iowa; Gillette, Wyoming; King County, Washington, St. Louis, Missouri; and Wadsworth, Ohio (the "Coalition") hereby submit comments in the above-captioned proceeding.[1]

2. The Coalition urges the Federal Communications Commission ("FCC") not to change its rules to permit operators to pass-through costs of system upgrades required by franchises. There is no rational basis for distinguishing between upgrades made pursuant to a franchise and upgrades made without such a requirement. Moreover, there is no need to allow upgrade costs to be passed through; the benchmark rates adequately cover

[1] First Order on Reconsideration, Second Report and Order and Third Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-428 (August 27, 1993) ("Third NPRM").

upgrade costs in most cases, and where they do not, the operator can present a cost of service showing. In addition, any method that accurately accounts for costs of upgrades only to the extent they exceed costs associated with the existing system is likely to be more complicated than a cost of service proceeding. Among other things, any pass-through formula would have to take into account increased revenues and cost savings that occur as a result of upgrades; if it did not, the formula would lead to unreasonable subscriber rates.

3. There is no reason to permit operators that recently began or completed upgrades to jump up to benchmark levels. That rule would reward operators that have delayed making system improvements, and might permit operators to double count for costs. A cost of service proceeding is the appropriate relief for any operator that believes benchmarks do not result in remunerative rates.

4. It is not clear that upward adjustments to benchmark rates are necessary to account for changes in channel capacity. However, if the FCC decides to adjust rates in response to channel additions or deletions, the Coalition supports the method the FCC tentatively approved in the Third NPRM, with several modifications designed to protect subscribers.

5. The Coalition agrees with the FCC that operators should be required to choose a single regulatory approach for all tiers. This requirement will discourage gaming and may well result in fewer cost of service proceedings. The Coalition also believes

that sharing of information and allowing rate proceedings to be consolidated will minimize duplicative work and promote fair and consistent rate decisions.

6. Operators appear already to be violating the FCC's itemization rules. The Coalition asks the FCC to reiterate its decision that operators must include franchise fees, taxes, and similar costs in the rates listed on subscriber bills, rate announcements and other public statements.

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Austin, Texas; Dayton, Ohio; Dubuque, Iowa; Gillette, Wyoming; King County, Washington; Montgomery County, Maryland; the City of St. Louis, Missouri; and Wadsworth, Ohio (the "Coalition") hereby submit comments in the above-captioned proceeding.[1]

I. UPGRADE COSTS SHOULD NOT BE TREATED AS EXTERNAL COSTS TO BE ADDED ON TO BENCHMARK RATES

In its Third NPRM, the Federal Communications Commission ("FCC") asks whether it should allow upgrade costs required by franchising authorities to be passed through as external costs. Members of the Coalition, and other governmental and consumer groups, have consistently opposed the allowance of <u>any</u> pass-

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[1] <u>First Order on Reconsideration, Second Report and Order and Third Further Notice of Proposed Rulemaking</u>, MM Docket No. 92-266, FCC 93-428 (August 27, 1993) ("Third NPRM").

throughs under the FCC's benchmark system. See e.g. King County, Washington et al., Petition for Reconsideration at 3-9, MM Docket No. 92-266 (filed June 21, 1993). All of the criticisms cited in that filing are equally applicable to pass-throughs of upgrade costs. Operators do have control over upgrade costs. Even where an upgrade requirement is contained in the franchise, it is the result of mutual agreement between the operator and the franchising authority, often within the parameters of federally mandated renewal procedures.

The benchmarks do not reflect the costs of a particular system; therefore, it makes no sense to add on certain costs based upon whether an upgrade was or was not required in a franchise. There is no justification for according different rate treatment to upgraded systems simply because there was an express requirement in the franchise. The franchising authority has the right and responsibility for ensuring that the cable operator provides adequate service in light of community needs. The proposed pass-throughs effectively punish franchising authorities that diligently carry out their obligations by eliciting a binding promise from the operator to make system improvements, and hence punishes franchising authorities that attempt to fulfill their obligation to "require cable operators to tailor the cable system" to satisfy local community needs and interests.[2]

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[2] Legislative History to Cable Communications Policy Act of 1984, 47 U.S.C. § 521 et seq., 1984 U.S.C.C.A.N. 4655, 4661 (1984).

A. <u>The Benchmarks Already Incorporate Costs of Upgrades.</u>

Allowing pass-throughs of upgrade costs will permit double-recovery of costs, and will not ensure reasonable rates. The very fact that the FCC's benchmark grids include systems with up to 100 channels reflects the fact that many of the systems used for developing the benchmarks have already been upgraded. A study submitted by a Multi-System Operator ("MSO") shows that the overbuild systems from which the benchmarks were derived were newer systems with significantly greater channel capacity than the random sample of systems not included in the FCC's benchmarks. <u>See</u> Petition for Reconsideration and Clarification submitted by Viacom International, Inc., RAND Corporation study at 9-11, MM Docket 92-266 (filed June 21, 1993) ("RAND Study"). Rates in those overbuild systems had already made significant system improvements, and costs of those improvements thus have been included in the FCC's benchmarks. <u>See also</u> Jay Smith Report, Exh. A (showing benchmarks more than recover upgrade costs). There is certainly no reason to suppose upgrades require <u>increases</u> in rates to recover costs. The RAND study submitted by Viacom International, Inc. indicates, if anything, the opposite: it states that per-channel rates on the overbuild systems are about 40 percent lower than rates in the random sampling of systems. <u>Id.</u> The study attributes the lower rates to the increased amount of programming provided due to the increased channel capacity. <u>Id.</u> at 10 n. 9.

Moreover, system upgrades are often planned for years.[3] Operators know of and plan for those expenditures, and include allocations for those expenditures in pre-upgrade rates. In addition, the cable industry has noted that there has already been significant upgrading of channel capacity and other advances. As a result, there is no room to suppose upgrade costs have not been recovered already in existing rates.

B. Passing Through Upgrade Costs Would be More Complex than Requiring a Cost of Service Showing

As a practical matter, passing through upgrade costs would be very complex, and would be more complicated than typical cost of service proceedings. The pass-throughs contemplated by the FCC's rate regulation only include cost increases that exceed inflation; that is, costs will be passed through only to the extent they exceed the existing costs incurred in providing service, increased by inflation. Therefore, to determine the appropriate upgrade pass-through, the regulator would be required to first determine the cost of the existing system. Then the cost differential between the original cost, adjusted for inflation, and the upgrade cost must somehow be determined. This calculation in itself would be more complicated than the

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[3] See e.g. Outlook for 93: Fiber on Parade, Multichannel News, November 30, 1992 at 3, 106 (noting that Time Warner has been "budgeting" and setting aside amounts for the past three years in anticipation of system improvements, and noting that Times Mirror Cable Television is in the midst of a five year fiber upgrade and rebuild program), Exh. B; Tele-Communications, Inc. (TCI) Accelerates Its Four-Year, $2 Billion, Nationwide Fiber Optic Construction Project (news release from TCI dated April 12, 1993), announcing plans for fiber upgrade over four-year period, Exh. C.

traditional cost of service determinations the Commission seeks to avoid.

Moreover, under the Commission's pass-through methodology, external cost increases must be reduced by decreases in external costs. Operators obtain significant financial benefits when they upgrade their systems (whether or not the upgrade is specified in the franchise). Among other things, upgrading the system attracts new subscribers, gives operators the opportunity to increase the number of revenue-producing services, such as home shopping programming, cable programming services, advertising and pay-per-view channels, improves security, reduces service and maintenance costs, and eliminates many costs of maintaining the existing system.[4] Upgrades may also enable the operator to collect new revenues from other communications services.[5] In

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4 Big Fibre Plans by US Cable TV Majors, Screen Digest, May 1993; Adelphia Plans to Deploy Fiber Much Further than Fiber-to-Feeder Design, Fiber Optics News, March 15, 1993; Jones Interdiction Test Nets Subs, Security and Cuts Costs, Multichannel News, February 22, 1993 at 48, 52; Outlook for 93: Fiber on Parade, Multichannel News, November 30, 1992 at 3, 106; Interdiction Compression -- What's an Operator To Do?, Multichannel News, July 8, 1991 at 42; Fiber Reaches Important Crossover: Experts, Multichannel News, June 4, 1990 at 46, Exhibit B. These articles contain admissions from the cable industry that it is probably no more expensive, (and may be less expensive) in the long run, to replace existing systems with fiber, and that any additional short-term costs are quickly recovered in cost savings. See also Tele-Communications, Inc. (TCI) Accelerates Its Four-Year, $2 Billion, Nationwide Fiber Optic Construction Project (news release from TCI dated April 12, 1993) (stating that cost of fiber has decreased 11 percent and cost of associated electronic components has decreased 40 percent since 1990), Exh. C.

5 See TCI's press release discussing potential new services it can provide as a result of system upgrade, Exh. C.

addition, system upgrades eliminate maintenance costs that the operator would otherwise incur, and thus provide certain cost savings.

All these new revenues and cost decreases would have to be considered before any pass-through were permitted. It is unfair to consider only the costs of upgrades, without also factoring in all the offsetting benefits. MacDonald v. Federal Power Commission, 505 F.2d 355, 364 (D.C. Cir. 1974), cert. denied, 421 U.S. 912 (1975) explains that revenues as well as costs must be considered in determining a fair rate. See also Duquesne Light Co. v. Barasch, 488 U.S. 299, 314 (1989) (costs should be offset out by revenues from other sources in regulatory context). It also is unfair to allow operators to allocate upgrade costs to regulated rates to the extent that the upgraded system will enable the operator to offer unregulated services. A large portion of the additional channels and capabilities provided by system upgrades go to unregulated services. See RAND Study at 10-11 (stating that overbuild systems -- which are newer and have greater channel capacity -- contain more premium and pay-per-view channels and rely less on revenues from basic service). See also Time Warner Plans Electronic 'Superhighway', The Wall Street Journal, January 27, 1993 at B1; Discovery Debuts Remote for 500-Channel Service, Multichannel News, December 14, 1992 at 1, 54, Exh. D. Particularly because the evidence shows upgrades do not require rate increases, imposing such a system hardly seems an improvement. This is not an improvement in either ease or accuracy over the FCC's existing method, which allows an operator to submit a cost of service showing if it believes the benchmarks are not remunerative.[6]

II. RECENTLY UPGRADED SYSTEMS SHOULD NOT BE ALLOWED TO INCREASE RATES TO BENCHMARK LEVELS

The FCC has suggested that it might decide to permit cable systems that have initiated or completed system upgrades "shortly" before rate regulation took effect to automatically increase rates to benchmark levels. The Coalition does not believe this is appropriate or necessary.

There is no rational basis for giving special treatment to recently upgraded systems. Such an allowance would give preferential treatment to some operators depending on when they made system improvements. And, there is no evidence before the Commission that suggests such an adjustment is necessary or appropriate, given the manner in which benchmarks were calculated, as shown above. In addition, system improvements will have attendant revenue benefits and cost savings that compensate for the initial cost outlays involved.[7]

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[6] If, in the interest of ease of administration, the FCC ignores apparent revenues and cost decreases, its action will lead to unjustifiable rate increases, which cannot be squared with the legislative mandate.

[7] See e.g. Big Fibre Plans by US Cable TV Majors, Screen Digest, May 1993 (TCI claims that cost of constructing fibre ring will be offset by same amount of savings in first year alone), Exh. B.

The Coalition urges the FCC not to permit "streamlined" showings that allow operators to increase rates merely by offering evidence of certain cost increases, without considering both costs and revenues overall. As the FCC has recognized in its Third NPRM, in any instance where pre-regulation rates did not factor in costs of upcoming system improvements, the operator will be free to submit evidence of its costs to try to justify a rate at or above the benchmark level. This is the showing incumbent upon any operator seeking to charge a rate other than that mandated by the benchmark system. There is no reason to give special rights to some operators simply because they have recently made or begun system improvements.[8]

III. THE FCC SHOULD USE ITS EXISTING METHOD FOR CALCULATING CHARGES IN THE NUMBER OF CHANNELS, WITH MINOR MODIFICATIONS

The FCC has asked what formula or methodology it should apply to its benchmark rate scheme to account for changes in the number of channels. Assuming the Commission continues to use its benchmark scheme, the Coalition believes that the formula tentatively approved by the FCC in its Third NPRM would be an appropriate method, with a few modifications. See Jay Smith Report at 1, Exh. A.

The system proposed by the FCC appears to give incentives to operators to drop broadcast channels and replace them with

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[8] It would reward operators who delayed making improvements, in some cases because the franchising authority expressly agreed to give the operator additional time to make improvements that had been promised.

satellite signals, because the per-channel benchmark rate goes up if the number of satellite channels is increased. The FCC should eliminate any such incentives to replace broadcast services. In addition, some operators are agreeing to help broadcasters launch new stations, as compensation for retransmission consent. Operators must be prevented from increasing subscriber rates because the operators have added channels rather than making direct payments to broadcasters. The FCC has already determined that initial costs of providing broadcast signals (in whatever form) are already included in benchmark rates. Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-177 (May 3, 1993), ("Report and Order"), ¶ 247. Operators should not be allowed to evade the one-year limitation on pass-throughs of retransmission consent fees by making non-cash payments.

IV. THE FCC IS CORRECT IN ITS BELIEF THAT OPERATORS SHOULD NOT BE ALLOWED TO CHERRY PICK BETWEEN METHODS OF RATE REGULATION

The FCC states in its Third NPRM that it has tentatively concluded that cable operators should not be able to choose different regulatory methods for different tiers. The Coalition supports this determination. Forcing operators to choose between cost of service and benchmark regulation is likely to lead to fewer cost of service proceedings, because cost of service showings will not be initiated unless the benchmarks overall are inadequate. Requiring a single choice will eliminate abuse and gaming, such as misallocation of costs and forum shopping, as the FCC acknowledges.[9]

The Coalition believes there are viable ways to reduce redundancies and minimize inconsistent decisions. In Reply Comments filed in the cost of service docket, Coalition members recommended ways in which cost of service proceedings could be consolidated. See Reply Comments of Austin, Texas, et al., MM Docket No. 93-215 at 29-31 (filed September 14, 1993). For example, those Reply Comments advocate requiring an operator that wishes to make a cost of service showing simply to notify all franchising authorities of the other communities in which the operator has initiated a cost of service proceeding.[10] The franchising authorities can then work together and share information. This minimizes the burden on both operators and franchising authorities, helps protect against misallocations and promotes consistent treatment.

In addition, an operator should not be permitted to stagger cost of service proceedings, but should be required to initiate

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[9] In some communities, for example, operators have told franchising authorities that they will attempt to make a cost of service showing for a rate slightly above the benchmark-derived rate. The franchising authority must then decide whether to undertake a costly and burdensome cost of service review, or allow the operator to charge an unjustified above-benchmark rate. Operators will be less likely to use (or misuse) the cost of service option if they are forced to present cost evidence and defend rates for all regulated services before the FCC as well as the franchising authority.

[10] Such a notification requirement is consistent with FCC requirements that franchising authorities and subscribers notify the operator when they take certain actions, such as filing for certification or filing a rate complaint.

proceedings on the same date for any tier in which it chooses to make a cost of service showing. Because franchising authorities are under tight deadlines for reviewing rates, and the FCC is not subject to comparable time limitations, cost of service decisions regarding basic rates will often be made before the FCC fully reviews or decides cost of service proceedings for non-basic rates. While it need not be binding, the decision by the franchising authority should be given considerable weight in the FCC's cost of service determination. The FCC would be entitled to (and should) rely on the franchising authority's determinations, as well as the evidence presented in the basic service proceeding, rather than duplicating the work.[11]

It makes no sense to permit an operator to go from cost of service to benchmark regulation. Once an operator makes a cost of service showing, it can increase rates for inflation (and, if the FCC continues to allow them, external cost adjustments), but it cannot subsequently try to rely on the benchmarks; by definition, a more accurate rate has been established.[12]

However, operators should be allowed to switch from benchmarks to cost of service regulation, at least if certain

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[11] This is particularly so because an operator may appeal a franchising authority's rate decision to the FCC.

[12] Operators should not be able to choose a cost of service approach and then, if dissatisfied with the resulting rate, try to arrive at a higher rate through the benchmark system. This would defeat the FCC's decision that, in making a cost of service showing, the operator runs the risk that the regulator may set rates below the benchmark. Report and Order, ¶ 272.

conditions have been met. The FCC appears to recognize that there must be protection against operator abuses, such as attempting to initiate a cost of service showing every month, thereby burdening the regulator without justification. The Coalition believes that the best way to protect against such abuse is to require an operator seeking to initiate a cost of service proceeding to make a threshold showing that benchmark rates do not enable the operator to earn a reasonable return on the overall system, including revenues from unregulated as well as regulated sources.[13] Alternatively, operators should be required to make a threshold showing that there has been a significant change in circumstances since the last regulatory review (under either the benchmark or cost of service system), warranting a cost of service review.

While operators should be able to move from benchmark to cost of service regulation in some circumstances, they should not be able to game the system. Thus, if an operator initiates a cost of service proceeding, the regulator must be permitted to examine the return earned by the operator when it relied on the benchmark in determining what rate is appropriate going forward. For example, if an operator claims that it needs to increase rates to cover costs of an upgrade, the regulator should be able to examine whether a benchmark-derived rate charged by the

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[13] See Comments of Austin, Texas et al. at 4, MM Docket No. 93-215 (filed August 25, 1993) and Reply Comments of Austin, Texas et al. at 2-5, MM Docket No. 93-215 (filed September 14, 1993).

operator allowed it to already recover the cost of the upgrade, and if so, the regulator might disallow the requested rate increase.

V. THE FCC SHOULD CLARIFY ITS ADVERTISING AND ITEMIZATION REQUIREMENTS TO PREVENT OPERATOR ABUSES THAT ARE OCCURRING

In its Report and Order, ¶ 551 (citing House Report prohibiting operators from identifying franchise fees as separate costs over and above charge for cable service) and 47 C.F.R. § 76.985(b), the FCC prohibits operators from failing to include costs attributable to franchise fees and taxes. However, many operators are listing their rates in advertisements and subscriber bills without including franchise fees and taxes and other similar costs, and are instead separating those charges out from services provided. For example, in the attached September 1, 1993 bill sent to subscribers in Gillette, Wyoming, Exh. E, franchise fees are for the first time broken out from rates. This practice appears to be occurring in many communities. Likewise, rate announcements sent by TCI, the cable operator in St. Louis, Missouri, stated that the listed rates did not include franchise fees or taxes. See rate announcement, Exh. F. As a result, the City of St. Louis sent a letter to TCI, notifying the operator that the rate announcement was unlawful. See September 8, 1993 letter to Gregory Schacher from Larry Stone, Exh. F. In response, TCI claimed that the rate announcement "was not an advertisement or other promotional material." See September 20, 1993 letter to Larry Stone from Gregory Schacher, Exh. F. This claim is particularly remarkable in light of the fact that included in the rate announcements were promotional materials for pay-per-view services. The Coalition believes that failing to include franchise fees and taxes in subscriber bills and rate announcements violates the FCC rules as well as federal law. It asks the FCC to make clear that such practices are unlawful.

Respectfully submitted,

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September 30, 1993

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EXHIBIT A

REPORT TO LOCAL GOVERNMENT COALITION REGARDING THE FEDERAL COMMUNICATIONS COMMISSION THIRD FURTHER NOTICE OF PROPOSED RULEMAKING TO IMPLEMENT RATE REGULATION SECTIONS OF THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992

(FCC 93-428; MM Docket 92-266)

September 30, 1993

Submitted by:

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Public Knowledge, Inc.
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About the Author

Mr. Jay C. Smith is president of Public Knowledge, Inc., a professional firm in Portland, Oregon providing financial analysis and operations consulting services. Over the past ten years, Mr. Smith has assisted over fifty local franchise authorities with financial aspects of cable television regulation, including franchising, renewal, rate regulation, and ownership transfer proceedings. During the course of his work involving cable television, he has reviewed historical financial statements and financial projections for numerous local systems. He has frequently served as an expert witness on issues relating to the economics of local cable system operations. Mr. Smith has also consulted to electric and other utility organizations on rate setting and cost allocation matters. He holds an undergraduate degree in economics and business administration and two interdisciplinary masters degrees from the University of Illinois. He has been a professional management consultant for 17 years, and is a Certified Management Consultant.

1. The Commission has proposed a reasonable method for use of the benchmark to adjust capped rates when channels are added or deleted from a regulated tier.

The Commission proposes that when there are channel additions or deletions to/from a regulated tier, the per channel benchmark rate should be the existing per channel rate adjusted for programming expense (Para. 139). In effect, the <u>average</u> existing programming expense per channel would be backed out of the existing per channel rate, this "pre-programming" rate would be adjusted by the percentage change in the benchmark reflective of the change in the number of channels, and the new <u>average</u> programming expense per channel would then be added back to derive the total rate per channel. It is not obvious that any upward adjustment to rates is necessary to account for changes in the number of channels. However, if there are to be any adjustments for programming costs at all when channels are added or deleted, the Commission's proposed approach is reasonable because:

- It constrains operators' ability to game the system by adding low or no cost channels (for example, bulletin boards or "barker" channels consisting solely or largely of advertising) to a regulated tier simply to manipulate rates, and it thereby protects consumers.

- It assures that operators will receive a return on investment (a component already embedded in the "pre-programming" per channel rate) and will not be discouraged from adding new programming because of cost (the programming cost will be fully recovered under the Commission's proposal).

- It recognizes "per channel" efficiencies associated with higher channel capacity.

The Commission can minimize the associated administrative expense and can promote data reliability and consistency by itself collecting the necessary programming cost information on a multiple system operator (MSO) basis. The Commission could then make this information available to local franchising authorities that request the information, although the primary authority to interpret and apply the information for the basic tier of service should reside with the franchising authority, as specified in the 1992 Act. The Commission will need to collect and maintain data for specific programming services, to allow local system adjustments to reflect the actual channel line-ups of the system. In performing this responsibility, the Commission must assure that the programming expenses applied in the calculations represent the costs of arm's length transactions, to prevent operators from manipulating reported programming costs to achieve higher rates. The Commission's collection of programming cost information from all MSOs will allow regulators to compare prices charged to affiliates versus non-affiliates of the program suppliers and to determine whether the data are consistently reported. Where the programming is provided by an affiliated supplier, the allowable programming cost should be no higher than the prices charged to non-affiliated operators. The allowable programming expenses should reflect the buying power of the MSO, and should not include add-ons to be passed down to local systems (for example, additional "management fees" or "marketing expenses")

2. No new special procedures need to be established to adjust benchmarks upwards for system upgrades.

(a) The Commission has already established a remedy for operators who believe that their costs justify rates higher than rates derived from the benchmark system. Operators may file cost-of-service showings in these circumstances. Provided that the Commission establishes reasonable cost-of-service rules, such showings may well be more straight-forward than trying to adjust benchmark rates for upgrade costs.

(b) Evidence before the Commission suggests that the current benchmarks will likely compensate operators for their costs, including the costs of system upgrades. For instance, a group of medium-sized operators (Group) submitted supplemental comments on August 4, 1993, including a report, "A Review of the FCC's Benchmark Formula and Proposed Revisions," prepared by Ernst & Young. The report presents upgrade cost information for eight systems. While the report purports to show that incremental revenue (under the benchmark formula) from added channel capacity resulting from an upgrade will not be sufficient to cover upgrade costs, when more appropriate assumptions are applied to the information, the data lead to the opposite conclusion. I made two adjustments to the assumptions applied by Ernst & Young. First, I spread the costs of the upgrade for each system over the entire channel capacity of the system, not just over the added channels resulting from the upgrade (as Ernst & Young did). My procedure is the appropriate one because upgrades affect entire systems, replacing capital in the pre-existing system that requires (or eventually would require) replacement, and affecting the signal quality, operating efficiency, and delivery capability for all channels. Second, I applied a 15 percent factor (instead of the 20 percent factor applied by Ernst & Young) to calculate an annual amount to cover return on investment and taxes. The figure I applied better reflects preliminary indications the Commission has given regarding the allowable rate of return, although the figure could be revised once the Commission has established its rules on the allowable rate. With these two modifications, I applied the Ernst & Young figures and assumptions.

My calculations show that for the eight systems the marginal benchmark revenue from an assumed ten additional regulated channels (Ernst & Young's assumption) would exceed the upgrade cost per channel by an average of 11¢ per subscriber per channel per month (attached Exhibit 1); the pre-programming expense margin for each of the nine systems would be positive. Contrary to the conclusion of the Ernst & Young report, this margin may be sufficient to cover or nearly cover the cost of programming likely to be included on the additional regulated satellite channels. Ernst & Young inappropriately compares the available margin to the overall average cost of satellite programming, which their report claims to be 20¢ per subscriber per month. More likely, marginal satellite channels added to an existing system will be services that cost less than the average. This is so because the popular services which can command higher prices are already carried on most systems, and the satellite services that would be added are likely to be less established, and therefore lower cost. In any event, the Commission's proposed approach to adjust benchmarks to reflect the actual cost of added programming (Para. 139) would assure that operators were compensated for their programming costs.

Moreover, much of the additional channel capacity resulting from upgrades is likely to be dedicated to unregulated services. These services offer the possibility that the operator can earn incremental revenue that substantially exceeds the per channel cost of the rebuild. For example, a channel providing an average of one pay-per-view event per subscriber per month at an average $3.00 price, and a programming cost at 50 percent of the subscriber price, would generate an incremental margin of $1.43 per subscriber per channel per month (assuming the 7¢ per channel average rebuild cost shown in Exhibit 1).

(c) Embedded capital costs are already reflected in the existing benchmark rates, and an additional rate increment for upgrade costs could provide "double recovery" over the extended life of the investment. The Commission's benchmark rates were set based on a price survey of a sample of cable operators. While costs were not specifically surveyed, it is fair to assume that the prices that were being charged by the surveyed systems were high enough to cover costs, including depreciation of capital plant and a return on plant investment.

Upgrades of plant generally extend the useful life of a cable system, thereby providing an additional period to recover depreciation and return on investment. That is, such investments replace or replenish depreciated assets. Therefore it would be inappropriate for the Commission to treat upgrade expenditures as an external cost additive to the plant investment already accounted for in the benchmarks.

In fact, certain information suggests that upgrades cost less than the plant investment cost embedded in the prices the Commission used to establish its benchmark rates. I reviewed financial and other information that I have collected for certain local cable systems in the past year to ascertain the average embedded plant investment. I selected 11 systems that were "modern" in the 1980s, typically 400 or 450 MHz, but not upgraded to current state-of-the-art standards (for example, 550 MHz or higher, substantial fiber deployment, etc.). These systems are summarized in Exhibit 2. The average embedded gross plant investment (excluding converters and drops) in these systems was about $580 per subscriber, or about 15¢ per subscriber per channel per month. These figures are notably higher than the approximately $360 upgrade investment per subscriber, or 7¢ per subscriber per channel per month, that I calculated using Ernst & Young's data for eight post-1991 upgrades.[1] This comparison is not conclusive because it is between two different sets of a limited number of systems, but it suggests that the investment per subscriber now necessary to extend the useful of a cable system for another life cycle (for example, 12 years) is less than the investment that was required for the previous life cycle.[2]

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[1] The comparison may even understate the difference in plant costs between the 1980s systems and the post-1991 upgrades because I excluded converter and drop costs from the figures used for the 1980s systems, whereas at least some converter and drop costs may have been included in the Ernst & Young figures for upgrades (the report does not provide sufficient detail to determine the composition of the "rebuild" costs).

[2] The comparison applies gross plant values, but the same relative results would be obtained for net plant values (less accumulated depreciation) if one assumes (as is reasonable) that the book lives of the upgrade assets will be the same as the book lives of the same classes of assets in the pre-upgrade period.